

## Chapter 1

# Understanding Fundamental Analysis

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### *In This Chapter*

- ▶ Getting a solid overview of why fundamental analysis is worth your time
  - ▶ Stepping through some of the main concepts that are critical to fundamental analysis
  - ▶ Understanding the ways that fundamental analysis can fit into many investment strategies
  - ▶ Grasping how to use this book to further your understanding of fundamental analysis
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**B**efore you gulp down that neon-colored energy drink or pour yourself a bowl of super-sweetened cereal that looks like it was made by Willy Wonka himself, you probably do something first. More times than not, you just might take a glance at the nutrition label that spells out what's in the box.

You might not know what guar gum, guarana, or other ingredients that often show up on the labels of such processed foods are, but you can get a pretty good idea of what's good for you and what's not. If a bottle of apple juice, for instance, has a list of ingredients longer than your arm and is filled with stuff you can't pronounce, you know you're not drinking squeezed apples. Being aware of what's in a food may or may not sway your decision to eat it, but at least you know what you're putting into your body.

Companies and stocks, too, come with similar labels. All companies that are *publicly traded*, or that lure money from the investing public, are required to disclose what they're all about. Just as food processors must list all the ingredients that go into their products, companies must tell investors what they're composed of.

Unfortunately, though, a giant multinational company can't put all the information investors need to know inside a tiny rectangle as food companies can. Instead, the key elements that make up a company are broken down at length in a series of *financial statements* and other sources of fundamental data.

Reading these critical financial statements and gleaning insights from them are the most basic goals of fundamental analysis. Fundamental analysis is the skill of reading through all the information companies provide about themselves to make intelligent decisions. Just as you'd want to know what's in that Frankenfood you're about to bite into, you want to know what's in an investment you're thinking about adding to your portfolio.

## *Why Bother with Fundamental Analysis?*

You might wonder why you need to hassle with fundamental analysis. After all, at every family picnic there's undoubtedly the loudmouthed relative who's filled with all sorts of can't-go-wrong stock tips. Why bother with technical things like net income or discounted cash flow analysis when you can just turn on the TV, write down a couple of stock symbols, buy the stocks and hope for the best?

Similarly, you might figure learning how companies operate is just needless information. After all, you don't need to know about fuel injection systems, suspensions, and car battery technology to drive a car. And you don't need to know what's going on behind the curtain to enjoy a play. Some investors figure they can just pick a couple of hot stocks, buy them, and drive off to riches.



If the vicious bear market that began in 2007 taught investors anything, it's that blindly buying stocks just because you might "like" a company or its products was hardly a sound way to tune up a portfolio. Chasing hunches and personal opinion about stocks is often not a great way to invest, as you'll find out in Chapter 20.

## *Some of the real values of fundamental analysis*

Ever notice how there's always a new wonder diet promising to make you skinny, and a new pill to make you healthier? More times than not, though, it seems these things never work. Getting healthy comes back to the basics — a balanced diet and exercise.

The same goes with investing. Believe it or not, investing can be somewhat full of fads. There's always a new investment pundit or economist with a new way to pick winning stocks. And just as an hour on the treadmill will do you

more good than a bottle full of miracle pills, successfully choosing stocks often comes back to fundamental analysis.

Fundamental analysis is the classic way to examine companies and investments for a variety of reasons, including the fact it is:

- ✔ **Based on fact, not opinion:** It's easy to get caught up in general enthusiasm about what a company is doing or the products it's selling. But fundamental analysis blinds you to this investment hype and gets you focused on cold-hard business realities. It doesn't matter if all the kids in your neighborhood are buying a company's products, if the company isn't making any money at selling them.
- ✔ **Good at pinpointing shifts in the business' health:** If a company's success is starting to fade, you'll see it show up on the fundamentals. No, there won't be a giant sign saying "Sell this stock." But there are clues if you know how to look, as you'll discover in Chapter 18. Companies are required to disclose key aspects of their business, so if there's a problem, a fundamental analyst will often be early at spotting some trouble.
- ✔ **All about execution:** Companies' CEOs are usually good at getting investors focused on the future and how things are going to get better next quarter. But the fundamentals are based in reality. Just think of children who say how hard they're working at school. The report card is still the tangible evidence of how things are actually going.
- ✔ **A way to put price tags on companies:** What's a painting worth? What's a used car worth? Just as with anything else with subjective value, the price is generally what someone is willing to pay for it. The stock market, an auction of buyers and sellers, does a good job putting price tags on companies. But fundamental analysis gives you another way to see just how much investors, by buying or selling stock, are paying for a stock.

## *Driving home an example*

One of the best recent examples of how fundamental analysis can help you and your portfolio is General Motors. For decades, GM represented the might of U.S. industriousness, know-how, and creativity. GM commanded a massive market value of \$3.5 billion in 1928, says Standard & Poor's. I'll step you through what market value means in more detail in Chapter 3, but for now, just know that GM was the most valuable company by far in 1928.

## GM vs. Ford

Even months before GM filed for bankruptcy protection, fundamental analysis could have served you well.

Back in January 2009, seeing both GM and Ford facing intense financial strain, many investors wondered if either one was worth taking a bet on. Some helpful fundamental analysis tools, including an analysis of the statement of cash flows, could have determined whether you lost a fortune or enjoyed a big gain.

I'll show you how to read the statement of cash flow in detail in Chapter 7. But for now, I'm just giving you a real example of why fundamental analysis matters to whet your appetite. At the beginning of 2009, both Ford and GM were constantly in the news. Both faced a tough business climate and both had depressed stock prices: Ford began 2009 at \$2.46 a share and GM \$3.65.

But a quick fundamental analysis showed Ford was the much better bet. Ford ended the quarter with \$27.5 billion in cash and burnt \$600 million

in cash. Don't let the numbers scare you at this point. I'm just exposing you to a basic free cash flow analysis, as you'll learn about later. Just for now, know that at the quarterly rate, Ford had enough cash to last nearly 46 quarters.

Over at GM, however, the company ended the quarter with just \$15.9 billion in cash. Meanwhile, it burnt through \$8.9 billion during the quarter. A fundamental analyst knew right away the company wasn't going to make it through the year at that rate. That's critical information to have known.

Knowing how to do this one type of fundamental analysis may make a world of difference for investors. In the following six months, shares of Ford jumped 149% to \$6.13. Ford also did not accept government funding assistance. Meanwhile, shares of GM crashed 79% to 75 cents.

Makes you want to read the rest of the book, doesn't it?

For decades, investors figured a dollar invested in GM was money in the bank. The company slugged through upturns and downturns and was a lasting power that helped drive the U.S. economy. The company kept paying fat dividends and kept powering profits higher.

But investors who blindly bet GM would remain a lasting force and ignored the fundamental signs of trouble suffered a brutal blow on June 1, 2009. On that day, which will forever remain one of the lowlights of capitalism, GM became the fourth-largest public company to seek bankruptcy protection, according to BankruptcyData.com. Shares of GM stock collapsed to just 75 cents a share, down 97% from their level just three years before.

Fundamental analysis may not have helped you predict this shocking outcome of GM. Concrete elements from the company's financial statements, though, could have tipped you off to just how challenged GM was well before it became a penny stock.

## *Putting fundamental analysis to work*

It's easy to get consumed with the fast-money trading aspects of stocks. Exciting TV reports about stocks on the move and companies that have new products practically turn investing into a sporting event. In fact, if you listen to some traders talk, they rattle off companies' ticker symbols in rapid-fire delivery just as sports fans talk about teams. Flashing arrows and rapid trading can become an addiction for people who get into it.

And it's exactly the headache and insanity fundamental analysis is trying to help you avoid. After all, stocks rise and fall each minute, day, and week based on a random flow of news. The constant ups and downs of stocks can sometimes confound logic and reason. Many readers of my Ask Matt column at USATODAY.com are baffled when a stock falls even after the company reports what appears to be good news. Trying to profit from these short-term swings is a game for gamblers and speculators. It's futile on a long-term basis.

But that's not to say investing is gambling. Remember that those stock symbols you see flashing red and green aren't dice, horses, or cards. They're more than just the two, three, or four letters of their ticker symbol.

When you buy a stock, you're buying a piece of ownership in companies that make and sell products and services. You're buying a claim to the companies' future profits. Owning a piece of a real business over time isn't gambling, it's capitalism.



Fundamental analysis forces you to focus on investing in businesses, not stocks. You're not buying a lottery ticket, but a piece of ownership in a company.

If jumping in and out of stocks at the right time isn't the way to riches, then what is the trick to successful investing? The answer is to stop thinking of stocks as just symbols that gyrate each day. The goal of fundamental analysis is to help you step away from the short-term trading and gambling of stocks. Instead, you approach investing as if you're buying a business, not rolling the dice.

Fundamental analysis ideally helps you identify businesses that sell goods and services for more than what they paid to produce them. Fundamental analysis is your tool to evaluate how good a company is at turning raw materials into profits.

Certainly, famed investor Warren Buffett is one of the best-known users of fundamental analysis. You will read more about how Buffett applies fundamental analysis to investing in Chapter 3.



No matter how you choose investments currently, you can likely apply fundamental analysis. Even if you're the kind of investor who likes to buy diversified mutual funds and hold onto them forever, called a *passive investor*, it can be helpful to understand basic financial characteristics of the companies.

## *Knowing what fundamentals to look for*

Knowing what makes a company tick isn't as convoluted as it may sound. Companies are so regulated and scrutinized, all the things you need to pay attention to are usually listed and published for all to see. Generally, when you hear about a company's fundamentals, the key elements to be concerned with fall into several categories including:

- ✔ **Financial performance:** Here you're looking at how much a company collects from customers who buy its products or services, and how much it keeps in profit. Terms you probably hear quite a bit about, such as *earnings* and *revenue*, are examples of ways fundamental analysts evaluate a company's financial performance.
- ✔ **Financial resources:** It's not enough for a company to sell goods and services. It's not even enough to turn a profit. Companies must also have the resources to invest themselves and keep their businesses going and growing. Aspects of a business, such as its assets and liabilities, are ways to measure a company's resources.
- ✔ **Management team:** When you invest in a company, you're entrusting your money with the CEO and other managers to put your cash to work. Fundamental analysis helps you separate the good managers from the bad.
- ✔ **Valuation:** It's not enough to identify which companies are the best. What's a "good" company anyway? Definitions of "good" can run the gamut. You also need to consider how much you're paying to own a piece of a company. If you overpay for the best company on the planet, it's still likely you'll end up losing money on the investment. You'll read more about this in Chapter 10 and Chapter 11.
- ✔ **Macro trends:** No company operates in a vacuum. A company's performance is highly influenced by actions of competitors or the condition of the economy. These broad factors need to be incorporated into fundamental analysis, as you'll discover in Chapter 15 and Chapter 16.

## *Knowing what you need*

One of the great things about running as a hobby is all you need is a pair of decent shoes. And basketball? Just grab a ball and find a hoop. No fancy equipment is required. The same goes with fundamental analysis. Much of the data you need is provided free by companies and can be accessed in seconds from any computer connected to the Internet.

Fundamental analysis can get pretty involved. But at its most basic form, there are just a few basic ideas behind fundamental analysis, including:

- ✓ **Awareness of the benefits of fundamental analysis:** Since fundamental analysis takes some know-how and time spent learning a bit, you'll want to know ahead of time why you're going to the trouble. Chapter 2 and Chapter 3 highlight the payoff of fundamental analysis. Even if you're a passive investor, or one who simply buys a basket of stocks and holds on, there are reasons why fundamental analysis might be worth your while.
- ✓ **Retrieval of financial data:** Getting all the key data you need to apply fundamental analysis is easy, if you know where to look. Chapter 4 gives you quick tips on how to round up all the data you'll need.
- ✓ **Basic math:** There it is: The M word. There's no way around the fact there will be some number crunching involved in some aspects of fundamental analysis. Don't worry, I'll guide you to help keep the math as painless as possible. One of the key tools you'll need is for trend analysis, which you will read about in Chapter 4.

## *Knowing the Tools of the Fundamental Analysis Trade*

You can read all sorts of books on home repair and even take a trip to your hardware store and buy lots of screws, nails and glue. But none of that effort will benefit you unless you have a tool-belt of hammers and the knowledge of how to get started and put your plan into reality.

The same importance of execution is part of fundamental analysis. You may appreciate the importance of fundamental analysis and may even be able to download fundamental data from Web sites or from a company's annual report. But you need to have the tools to analyze the fundamentals to get any real value from them.

## *Staying focused on the bottom line*

If there's one thing investors may agree is of utmost importance, it's the company's profitability. When it comes down to it, when you invest in a stock you're buying a piece of the company's profitability. Knowing how to read and understand how much profit a company is making is very important when it comes to knowing whether or not to invest.

The income statement, described in full detail in Chapter 5, will be your guide when you're trying to determine how profitable a company is. What might also surprise you is that the income statement can tell you a great deal about a company, in addition to just how much income it brings in.

## *Sizing up what a company has to its name*

During times of intense financial stress, investors often make a very important mental shift. They're not so concerned about making money as they are about just getting their money back. Similarly, when things get tough in the economy, investors are less interested in how profitable a company is and are more mindful of whether a company will survive.

When you're trying to understand the lasting power of a company, fundamental analysis is of great value. By reading the company's *balance sheet*, you can get a rundown of what a company has — its *assets* — and what it owes — its *liabilities*. Monitoring these items give you a very good picture of how much dry powder a company has to endure a tough period. Chapter 6 explores the balance sheet in more detail.

## *Burn baby burn: Cash burn*

One of the biggest killers of companies, especially smaller firms just starting out, is cash flow. While a company might have a great product concept, excellent management, and even dedicated financial backers, timing is everything. If a company is using up cash to pay its bills and employees but not bringing in enough cold hard cash from customers, it can run into a giant financial headache very quickly.



If there's one thing I hope you pick up from this book, it's how fundamental analysis helps you keep a close eye on how much cash is coming into and out of a company. Monitoring cash flow is critical to know if a company is running perilously empty on cash, which you'll dig into in more detail in Chapter 7. But cash flow is also a very important way fundamental analysis helps you put a price tag on a company, as you will find out about in Chapter 11.



## *Financial ratios: Your friend in making sense of a company*

As you flip through the book and jump around to different topics that interest you, you might be a bit bewildered by just how many pieces of data fundamental analysts must deal with. You've got the financial statements that measure just about every aspect of the company. It can be intimidating to decide what numbers matter most and which ones can be ignored.

Financial ratios will be a great help here, as you'll see in Chapter 8. These ratios draw all sorts of fundamental data from different sources and put them into perspective.

Financial ratios are also important because they form the vocabulary of fundamental analysts. If you're ever at a cocktail party where analysts are talking about gross margins and accounts receivable turnover, I want you to be prepared. By the way, that sounds like a pretty boring party.

I'll show you a whole host of financial ratios in Chapter 8 that are the favorites used by many fundamental analysts. You'll soon be using seemingly unrelated pieces of financial data about a company to glean some very important conclusions about the company.

## *Making Fundamental Analysis Work For You*

Imagine a young child who memorized an entire dictionary, but can't use a single word in a sentence. That's a basic analogy of some investors' fundamental analysis knowledge. You might, too, know some things about the income statement and balance sheet and have a great knowledge of what's contained in the statements. But when it comes to applying your know-how, that can be a bit trickier.

Putting fundamental analysis in action requires taking everything you know about a company and mixing in some estimates and best guesses about the future to arrive at a decent expectation of whether or not to invest in a company.

## Using fundamentals as signals to buy or sell

Buying a stock at the right time is very difficult. But knowing when to sell it is even tougher. And while fundamental analysis won't tell you the exact best time and day to buy or sell, it can at least give you a better understanding of things to look out for when it comes to making decisions.



If you're a passive investor and buy large diversified baskets of dozens of stocks, you can afford to buy and hold stocks. Even if one company runs into big-time trouble, it's just one holding in a large basket of stocks. However, if you choose to invest in individual stocks, monitoring the fundamentals is critical. If you start noticing a company's trend deteriorating, you don't want to be the last investor to get out.

## The perils of ignoring the fundamentals

Blindly following a company and investing in its stock can be very dangerous. Table 1-1 shows a list of a few major U.S. stocks that were worth \$100 a share or more at the beginning of 2000, but saw their share prices fall to below \$10 a share by the start of 2009. Ouch!

<b>Table 1-1</b>	<b>Watch Out! A Falling Knife!</b>	
<b>Stock</b>	<b>Stock price 12/31/1999</b>	<b>Stock price 1/1/2009</b>
JDS Uniphase	\$645.25	\$3.65
InfoSpace	\$535.00	\$7.55
Blue Coat Systems	\$326.72	\$8.40
Ciena	\$201.25	\$6.70
Sun Microsystems	\$154.88	\$3.82

*\*Source: Standard & Poor's Capital IQ*



If there's a primary goal of fundamental analysis, it's avoiding stock disasters like the ones listed above. Losses that large are nearly impossible to recover from in a single person's lifetime. You can read more about why avoiding investment disasters is so critical in Chapter 18.

## *Using fundamental analysis as your guide*

As Table 1-1 shows, investing in individual stocks is very risky. Losses can be sizeable. That's why you want to invest with your eyes wide open. Just as you probably wouldn't dare fire a loaded weapon or jump out of an airplane without proper training, the same goes with investing in individual stocks.

Luckily, fundamental analysis provides investors with a host of very specific tools to help them protect themselves. And while the tools of fundamental analysts aren't foolproof, as you will see in Chapter 22, they give investors guidance of when a stock might be getting a little dangerous or the underlying trends might be changing.

You'll find complete explanations of some of the most powerful tools used by fundamental analysts in this book. Chapter 11, for instance, will be very valuable to you since it shows you how to use a company's cash flow as a way to measure its value. And in Chapter 12, you'll discover how the pros spin through the annual reports they receive from companies.

